No. 12,750

In the United States Court of Appeals for the Ninth Circuit

LUCILLE McGAH, E. W. McGAH, CAROLE O'SHEA AND JOHN P. O'SHEA, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

THERON LAMAR CAUDLE,
Assistant Attorney General.

ELLIS N. SLACK,
A. F. PRESCOTT,
CARLTON FOX,
Special Assistants to the Attorney General.

INDEX

	Page
Opinion below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	2
Summary of argument	6
Argument:	
There is ample evidence to support the Tax Court's finding that, in the taxable year here in question, the taxpayers held 14 houses primarily for sale to customers in the ordinary course of their trade or business, within the meaning of Section 117 (j) of the Internal Revenue Code	8
Preliminary	8
A. To sustain the Tax Court's decision on the facts of this case, it is immaterial how the word "primarily" is defined in the context of Section 117	9
B. Under the decisions of this Court, the question whether property is primarily held by the taxpayer for sale in the ordinary course of a business is regarded as depending solely on the nature and extent of his sales activities	9
C. The Supreme Court has defined the word "principal" to mean "fundamental," "essential," and hence "substantial" in a similar situation where it regarded it necessary to do so in order to implement the purpose of the statute	9
D. The legislative history of the capital gains provisions discloses a continuing Congressional purpose sharply to distinguish taxwise between property held for sale in the ordinary course of a trade or business and that which was not so held	9
E. The facts in the case at bar, together with proper inference to be drawn therefrom, sustain the Tax Court's finding on any view that may be taken of the statute	9
Conclusion	22
Appendix	23

CITATIONS

Cases:

Albright v. *United States,* 173 F. 2d 399	19
Balestrieri, Joe, & Co. v. *Commissioner,* 177 F. 2d 867	15
Bohannon, David D. v. *Commissioner,* No. 12,729	8
Brown v. *Commissioner,* 143 F. 2d 468	19

Cases—Continued

Page

Commissioner v. *Boeing,* 106 F. 2d 305, certiorari denied, 308 U. S. 619 18
Delsing v. *United States,* 186 F. 2d 59 .... 18, 21
Ehrman v. *Commissioner,* 120 F. 2d 607 .... 18, 19
Elgin Building Corp. v. *Commissioner,* decided February 15, 1949 20
Farry v. *Commissioner,* 13 T. C. 8 21
Ferguson v. *Commissioner,* decided March 21, 1950 20
Field v. *Commissioner,* 180 F. 2d 170 18
Harvey v. *Commissioner,* 171 F. 2d 952 19
Helvering v. *Nat. Grocery Co.,* 304 U. S. 282 10
Helvering v. *Stock Yards Co.,* 318 U. S. 693 15
Richards v. *Commissioner,* 81 F. 2d 369 18
Robertson v. *Commissioner,* decided September 29, 1949 20
Rollingwood Corp. v. *Commissioner,* No. 12,728 .... 6, 8
Rubino v. *Commissioner,* 186 F. 2d 304 .... 9, 18
Snell v. *Commissioner,* 97 F. 2d 891 19
Stone v. *United States,* 164 U. S. 380 15
Texas & N. O. R. Co. v. *Ry. Clerks,* 281 U. S. 548 14
United States v. *Bennett,* 186 F. 2d 407 19

Statute:

Internal Revenue Code, Sec. 117 (26 U.S.C. 1946 ed., Sec. 117) 23

Miscellaneous:

Treasury Regulations 111, Sec. 29.117-7 24

In the United States Court of Appeals for the Ninth Circuit

No. 12,750

LUCILLE McGAH, E. W. McGAH, CAROLE O'SHEA AND JOHN P. O'SHEA, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion is the Tax Court's opinion, promulgated July 31, 1950 (R. 64-82), which is reported in 15 T. C. 69.

JURISDICTION

The taxpayers E. W. and Lucille McGah are husband and wife, as are also the taxpayers John P. and Carole O'Shea, making their returns on the community property basis. Their joint petition for review (R. 87-98) involves deficiencies determined by the Commissioner in the federal income taxes of each for the fiscal year of a partnership ended October 31, 1944, of which

E. W. McGah and John P. O'Shea were the sole partners, in amounts as follows: Against E. W. McGah, $8,452 (R. 33); against Lucille McGah, $8,452.01 (R. 18); against John P. O'Shea, $2,337.30 (R. 61); and against Carole O'Shea, $2,337.28 (R. 47). On July 26, 1948, the Commissioner mailed each taxpayer a notice of deficiency. (R. 28-33; 13-18; 57-61; 43-47.) Within 90 days thereafter, and on October 25, 1948, each of the taxpayers filed a petition with the Tax Court for a redetermination of such deficiency, under Section 272 (a) (1) of the Internal Revenue Code. (R. 20-33; 5-18; 50-61; 36-47.) The proceedings were, by joint motion of the parties, consolidated for hearing before the Tax Court. (R. 5.) The decision of the Tax Court in each proceeding that there was a deficiency in the tax was entered July 31, 1950. (R. 84; 83; 86; 85.) The proceedings are brought to this Court by petition for review filed October 26, 1950 (R. 87-98), under the provisions of Section 1141 (a) of the Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether there is evidence to sustain the Tax Court's finding that, in its fiscal year ended October 31, 1944, San Leandro Homes Company, a partnership of which the taxpayers, E. W. McGah and John P. O'Shea, were the sole partners, held 14 houses primarily for sale in the ordinary course of its trade or business, within the meaning of Section 117 (j) of the Internal Revenue code.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*.

STATEMENT

The facts were presented to the Tax Court partially by stipulation (R. 147-192) and partially by oral testi-

mony (R. 112-145). Its findings (R. 66-72) may be summarized as follows:

E. W. McGah and John P. O'Shea (referred to herein throughout as the taxpayers) were equal partners doing business under the firm name of San Leandro Homes Company, organized by them in 1942, whose business was building homes.[1] The partners contributed $13,500 in cash to the working capital of the partnership, which had been organized to construct 169 defense houses. The partnership obtained 169 lots in the City of San Leandro, California, in connection with which it assumed obligations of the seller of $88,725. On September 17, 1942, the partnership obtained preference ratings to build these houses, pursuant to which it was required to rent each of 69 of them for $39.99 per month and each of the remaining 100 for $50 per month. The priority ratings given the partnership did not, however, impose any restrictions upon the sale of the houses. The houses were constructed with "one hundred per cent [F.H.A. guaranteed] loans." In all, $676,000 was thus borrowed, i.e., $4,000 for the construction of each house, which was the cost thereof. (R. 66-69.) As the construction progressed, the tax-

[1] With respect to the taxpayers, Lucille McGah and Carole O'Shea, it is sufficient to say that, as explained more fully under the heading "Jurisdiction," *supra*, Lucille McGah was the wife of the taxpayer, E. W. McGah, and Carole O'Shea was the wife of the taxpayer, John P. O'Shea. Since one-half of the profits of the partnership here in question constituted the community property of McGah and his wife and one-half thereof the community property of O'Shea and his wife, the wives filed separate returns for the taxable year 1944, here in question, in which each reported her share of community profits, and the Commissioner determined separate deficiencies against each in respect thereof. (R. 65.) McGah and O'Shea were also members of several other partnerships in 1944, in one of which, namely, Brennan, McGah and O'Shea, McGah and O'Shea each had a 25 percent interest. This firm was also engaged in the construction and sale of F.H.A. financed houses and constructed and sold 121 of them in 1944. (R. 66.)

payers knew that the sales price of each house would be close to $5,000 or $5,100. They also knew that it would be unprofitable to rent any of the houses for $39.99 per month, though they considered that their rental at $50 per month would be profitable. (R. 69.)

When, at the end of 1942 or in the beginning of 1943, the taxpayers ascertained that they would not be permitted to charge more than $39.99 rent for each of the 69 houses referred to, they decided to sell them, together with 5 others situated in their immediate vicinity, and did sell, altogether, 74 houses during the partnership's fiscal year ended October 31, 1943, at a net profit of $88,691.20. None of these houses had ever been rented. (R. 69-70.) Each of the remaining 95 houses were rented from and after March 15, 1943, at $50 per month and were occupied by 156 different tenants between that time and August 14, 1944. (R. 70.)

In the middle of March, 1944, the taxpayers wished to borrow more money for the construction of additional houses, and their bankers thereupon suggested to them, in a manner which was more or less a demand, that they liquidate some of their properties in order to reduce their bank indebtedness. Accordingly, the taxpayers decided to sell some of the houses. There was a large demand for them at that time. And, as tenants moved out, they sold 14 of the houses through brokers in the partnership's fiscal year ended October 31, 1944; 31 in its fiscal year ended October 31, 1945; 12 in its fiscal year ended October 31, 1946, plus an additional house purchased and rented during that year; and 3 in its fiscal year ended October 31, 1947. Thus, during the period from about March 15, 1943, to October 31, 1947, 134 out of the 169 houses built were sold, leaving 35 on hand, which were all rented. (R. 70-71.) Selling prices ranged from $5,500 to $6,000,

and the net profit per house sold from $1,768.69 to $2,281.61. The net profit on the sale of the 14 houses sold in 1944 was $27,936.51, of which $17,176.20 was realized in that year under installment payments. The sales of the houses made during the three months' period remaining in the partnership's fiscal year ended October 31, 1944, were continuous and frequent. The profits from rents during the partnership's fiscal year ended October 31, 1944, amounted to $4,306.63; they amounted to $2,449.40 in its fiscal year ended in 1945; there was no profit from rents in its fiscal year ended in 1946, but a loss of $1,209.67; and, in its fiscal year ended in 1947, there was a rental profit of $629.57. (R. 71-72.)

In the middle of 1944, the partnership made further application for loans from the same bank, which were eventually obtained. With these it built more houses, which, with the exception of a few that were rented, were also sold. (R. 72.) On the basis of the evidentiary facts thus found, the Tax Court further found that, shortly before August 1, 1944, the taxpayers decided to sell the houses in order to obtain capital for further construction operations, and that they then abandoned the purpose of holding the houses primarily for the production of rental income; that they decided to sell the houses as tenants occupying them under oral month-to-month tenancies vacated them; that the business of the partnership from August 1, 1944, to the end of its fiscal year ended in 1944, was the sale of houses and that during this fiscal year the houses were held by the taxpayers primarily for sale to customers in the ordinary course of their trade or business, and not primarily for investment purposes. (R. 72.)

Accordingly, the Tax Court sustained the Commissioner's determination. (R. 82.)

SUMMARY OF ARGUMENT

The case of *Rollingwood Corp.* v. *Commissioner,* No. 12,728, pending in this Court on the taxpayer's petition for review of the decision of the Tax Court therein, presents the same question here presented, upon a somewhat similar state of facts. The several arguments made by the Government in its brief in that case leading up to a discussion of the facts therein are pertinent here and are therefore incorporated herein by reference.

As in the *Rollingwood* case, so here, the evidence adduced before the Tax Court sustains its finding that the houses in question were held by the taxpayers, in the taxable year here in question, primarily for sale to customers in the ordinary course of their trade or business. This Court has consistently held that whether property is held by a taxpayer primarily for sale, within the meaning of the capital gains provisions of the federal taxing statutes, is essentially one of fact. The result is that the taxpayers are not entitled to a review of those facts here as upon a trial *de novo.* But that is precisely what they seek here.

The testimony of the taxpayer O'Shea, upon which the taxpayers particularly rely, was discredited by the Tax Court. This is to the effect that they constructed 95 of a total of 169 houses as a rental investment project and continued so to hold them in the taxable year here in question. It was principally on the basis of this testimony that the taxpayers made two contentions below, which they repeat here, namely, (1) that when the houses were completed in about February 1943, their purpose was to hold the 95 houses, above mentioned, for investment purposes, to be rented, and thereby to produce income in accordance with an investment purpose, and (2) that a valid differentiation was to be made, between their purpose with respect to a group of 74 of a total of 169 houses built by them in

1942, which they had sold in 1943, and their purpose with respect to the remaining 95 houses, 60 of which they sold in the years 1944 to 1947, inclusive.

Assuming, nonetheless, but only *arguendo,* that these contentions of the taxpayers were sound and supported by the evidence, the Tax Court found that, when they determined to sell the 95 remaining houses, or at least some of them, in 1944, they "abandoned" their purpose of holding them "primarily for the production of rental income." The taxpayers' contention that there is no evidence to support this finding is pointless, in view of the fact that their sales activities were substantial, both in point of the volume of sales and of their continuity. Other circumstances confirm this view, such as the fact that their obligations to the bank on loans with which the houses were constructed could not have been discharged except by the sale of the houses; also that their profits from such sale far exceeded their profits from rentals. The retention for rental purposes of the remaining 35 debt-free houses does not support the taxpayers' contention as to their alleged primary rental purpose. Nor does the evidence support their contention that they expected to pay for the houses out of depreciation allowances. These were not nearly enough to discharge the loans.

The taxpayers cannot complain that their purpose was judged by what they actually did.

The cases upon which the taxpayers rely to sustain their contention do not in fact do so. Each of these was decided upon its own particular facts. No general principles were laid down or applied in them which, if applied here, would require a reversal.

ARGUMENT

There Is Ample Evidence to Support the Tax Court's Finding That, in the Taxable Year Here in Question, the Taxpayers Held 14 Houses Primarily for Sale to Customers in the Ordinary Course of their Trade or Business, Within the Meaning of Section 117 (j) of the Internal Revenue Code

Preliminary

The case of *Rollingwood Corp.* v. *Commissioner,* No. 12,728, brought to this Court by the taxpayer therein for review of an adverse decision of the Tax Court, with the case of *David D. Bohannon* (as transferee of the corporation's assets) v. *Commissioner,* No. 12,729, presents the same question upon a somewhat similar state of facts as is presented in the case at bar. That is to say, the ultimate question in the *Rollingwood* case, as here, is whether the evidence sustains the finding of the Tax Court that houses built with F.H.A. guaranteed loans were held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business.

To be sure, all of the facts in the *Rollingwood* case were stipulated, whereas, here some oral testimony was adduced by the taxpayers in order to supplement the stipulated facts. Even so, Subpoints A to D, inclusive, made by the Government in its brief in the *Rollingwood* case, and leading up to Subpoint E, wherein the facts in that case were marshalled, are pertinent here and, if not incorporated by reference, would have to be repeated here. Since we do not deem it necessary to do that, we shall content ourselves with referring the Court, as well as taxpayers' counsel in the case at bar thereto; and, in order to advise counsel of the nature of the arguments made by the Government in its *Rollingwood* brief in support of those points, we are serving copies of the brief in that case upon them, together with copies of the Commissioner's brief in this case.

The points referred to are as follows:

A. *To sustain the Tax Court's decision on the facts of this case, it is immaterial how the word "primarily" is defined in the context of Section 117* (See *Rollingwood* Br. 6-7.)

B. *Under the decisions of this Court, the question whether property is primarily held by the taxpayer for sale in the ordinary course of a business is regarded as depending solely on the nature and extent of his sales activities* (See *Rollingwood* Br. 7-9.)

C. *The Supreme Court has defined the word "principal" to mean "fundamental," "essential," and hence "substantial" in a similar situation where it regarded it necessary to do in order to implement the purpose of the statute* (See *Rollingwood* Br. 9-11.)

D. *The legislative history of the capital gains provisions discloses a continuing Congressional purpose sharply to distinguish taxwise between property held for sale in the ordinary course of a trade or business and that which was not so held* (See *Rollingwood* Br. 11-15.)

We turn to a discussion of the facts in the case at bar.

E. *The facts in the case at bar, together with proper inferences to be drawn therefrom, sustain the Tax Court's finding on any view that may be taken of the statute*

As pointed out under Subpoint B in the *Rollingwood* brief, *supra,* this Court has consistently held that whether property is held by the taxpayer primarily for sale within the meaning of the capital gains provisions of the Internal Revenue laws is primarily one of fact. The *per curiam* decision of the Court in the case of *Rubino* v. *Commissioner,* 186 F. 2d 304, which is the last case decided by this Court involving the same question, is expressly predicated upon that view. That

being so, we think it pointless for the taxpayers to reargue their case here, as upon a trial *de novo,* which is what they have done. See *Helvering* v. *Nat. Grocery Co.,* 304 U. S. 282, 394-395. The fact that review of the decisions of the Tax Court now proceeds upon the principles of the review of the District Courts in nonjury cases does not signify that the taxpayer is entitled to another trial on the facts here, or that on such trial, it is entitled to have this Court evaluate anew the credibility of the witnesses and the weight to be given their testimony in the framework of the facts as otherwise established, taken together with the reasonable inferences to be drawn therefrom, which may or may not be in accord therewith depending upon the view taken by the trier of the facts. And yet, that is precisely what the taxpayers seek to have this Court do.

Thus, the taxpayers contend (Br. 21-30) that, when the 169 houses were built in February 1943, their purpose was to hold all of them for investment purposes, i.e., to hold them for rental, with the exception of 69 of them (later increased to 74), which could not be rented at a profit because of the low rent which the taxpayers were required to charge therefor under the priority application. In this connection, the taxpayers further contend that they did not abandon the purpose in 1944 with respect to the 95 houses which remained after the sale in 1943 of 74 of them, when they determined in the middle of 1944 to sell at least some of the remaining houses as they became vacant, and when, in accordance with such determination, they sold 14 of them in the last three months of the partnership's fiscal year ended October 31, 1944.

The Tax Court made it perfectly clear in its opinion (R. 74-75) that it regarded the taxpayers' contention, that upon the completion of the houses they intended to hold 95 of them for investment purposes, as unsound

and that it did so because it gave little or no credence to the only evidence supporting it. This was the testimony of the taxpayer O'Shea, who had testified that it was his, as well as his partner, McGah's, intention to retain the 95 houses referred to as a rental investment, and that, therefore, a valid distinction was to be made between the taxpayer's primary purpose with respect to the 74 houses, which admittedly was their sale, and the taxpayers' primary purpose with respect to the remaining 95 houses, which assertedly was their rental. But, as we shall presently undertake to show, there is literally no evidence in this record, aside from the testimony of O'Shea referred to, which would justify an inference that the taxpayers' purpose had ever been to hold either all of the houses, or all of them but the 74 which they sold in 1943, as a rental investment project. The best that can be said of the evidence adduced is that, as the Tax Court found, the taxpayers originally contemplated renting all of the houses, provided that all could be rented for $50 per month. (R. 68.) And, of course, as we have said, they soon found out they could not do that; the upshot being that they commenced to sell the houses and did not stop until all but 35 of them had been sold, which, as we shall presently show, undoubtedly became debt free as a result of the sale of the others.

In any event, the Tax Court found that the taxpayers soon found out, as stated, that they could not get permission to raise the rent of the 69 houses from $39.99 to $50 per month, and that they accordingly decided to sell them, together with five others situated in their vicinity, making 74 in all, and that they did so in 1943 at a profit of $82,691.20. (R. 69-70.) In this connection, the Tax Court further found that thereafter, about the middle of 1944, the taxpayers' bank suggested, in a manner which indicated a demand, that,

in view of the fact that they wanted to borrow more money in order to build more houses, which they did, they liquidate some of the houses they then owned, since they already owed the bank in excess of $350,000. They immediately resumed their sales activities, and did not stop until at the end of the fiscal year ended on October 31, 1947, they had sold all but the 35 houses above-mentioned. They sold 14 of these houses in the last three months of the partnership's fiscal year ended October 31, 1944; 31, in its fiscal year ended October 31, 1943; 12, in its fiscal year ended October 31, 1946, plus an additional house which they had purchased and rented that year; and 3, during the partnership's fiscal year ended October 31, 1947. Thus the taxpayer's sold 134 of the original 169 houses, leaving only 35 of them on hand in 1947, as stated, which they have continued to rent. (R. 69-71.) Since the houses sold for between $5,500 and $6,000, the taxpayers' profit on the sale of each was between $1,500 and $2,000. (R. 71.)

Moreover, as the Tax Court pointed out in its opinion (R. 74), the houses cost $4,000 to build and, since they were built entirely with money borrowed on F.H.A. guaranteed loans, such loans must have aggregated $676,000 (169 x $4,000). Indeed, it is this circumstance which caused the Tax Court to pose the obvious question as to how the taxpayers expected to pay the loans which they had obtained to build the houses and how long it would take to work out the project from the viewpoint of the financing which was adopted. But the only answer to this question is the obviously disingenuous assertion of O'Shea that, at the time they made the application for priorities, it looked as if the project would be a very advantageous one to them financially, inasmuch as they could procure 100 percent loans from the bank through the F.H.A. insurance and by so

doing could receive 100 percent on no investment at all. (R. 129.)

In a belated attempt to support this assertion here, the taxpayers now argue (Br. 55) that the depreciation allowances, which they figure at $201.18 per house per year, would in the 20 years for which the loans were authorized have paid them off. The difficulty with this assertion is twofold.

In the first place, neither of the taxpayers made any such calculation when they went into the venture. While depreciation was mentioned by O'Shea in a general way in his cross-examination, he testified that they did not know what their depreciation allowances would be at the time they built the houses, and not until some years later. (R. 139.) In the second place, it appears from the record that, in the years 1942 and 1943, the depreciation was actually figured on the basis of a 16⅔-years life for the houses (R. 169, 175), and there is no evidence that it was figured upon any other basis thereafter. But a $201.18 depreciation allowance per house per year would amount to only $3,528.88 in 16⅔ years.

On the other hand, the sale of the 95 remaining houses at a minimum of $5,000 each was obviously more than enough to pay off the loan of $4,000 on each of them. In this connection, McGah had testified that, at the time the houses were built, he knew they would all sell for approximately from $5,000 to $5,100 each and that, as they got along on the project, they knew what profit they would make per unit upon the sale of the houses. (R. 138.) Of course, the 14 houses here in question actually sold in 1944 and 1945 for from $5,500 to $6,000 each, as stated, and the net profits on each house sold ranged from $1,768.69 to $2,281.61. (R. 71.) Similarly, the 74 houses sold in 1943 had been sold at a net profit of more than $82,691.20, or at a net profit of

more than $1,000 per house. (R. 70.) In other words, they, too, must have been sold for more than $5,000 each.

Moreover, since, as has already been indicated, the taxpayers received on the sale of the 60 houses which they sold between 1944 and 1947 an amount far in excess of the construction loans they had made on them, it is reasonable to assume that they had wiped out their entire indebtedness to the bank so far as concerns this property and that, consequently, the 35 houses which they had retained were then debt free. Indeed, as their sales progressed, their debt to the bank must have been reduced from time to time, so that it became less and less burdensome, until it was finally wiped out. Of course, in the meantime, the taxpayers continued to rent the houses until they were sold. But, from that fact alone, no inference need necessarily be drawn either of an original or of continuing primary purpose to hold the houses as a rental investment project, as the taxpayers contend. (Br. 28-29.) And, certainly, no such inference is justified from the fact that they held a relatively small residue of debt free houses for rent after 1947.

In short, the fact of the matter is that the taxpayers had no adequate way to pay off the loans other than by selling the houses, and this they accordingly did. It cannot be gainsaid that the taxpayers had a profit motive in entering into this transaction. Nor can it be gainsaid that their conduct was equivocal. The taxpayers, therefore, cannot complain because their equivocal conduct was viewed by the Tax Court in the light of their manifest interest and purpose. As Mr. Chief Justice Hughes said in his opinion in *Texas & N. O. R. Co.* v. *Ry. Clerks,* 281 U. S. 548, 559-560:

> Motive is a persuasive interpreter of equivocal conduct, and the petitioners are not entitled to

> complain because their activities were viewed in the light of manifest interest and purpose. The most that can be said in favor of the petitioners on the questions of fact is that the evidence permits conflicting inferences, and this is not enough.

It is thus apparent that, since, in the circumstances here, the Tax Court, was obviously not required to accept the testimony of the taxpayer O'Shea (See *Joe Ballestrieri & Co.* v. *Commissioner,* 177 F. 2d 867, 874-875 (C.A. 9th), and cases there cited; also *Helvering* v. *Nat. Grocery Co., supra* (304 U. S. 282, 295), and *Helvering* v. *Stock Yards Co.,* 318 U. S. 693, 701), there is no evidence to compel a finding that they held these houses primarily for rent rather than for sale.[2]

This, then, is the background of the Tax Court's theory of "abandonment," against which the taxpayers so strenuously inveigh. (Br. 21-58.)

The precise finding of the Tax Court in this respect is that, shortly before August 1944, the taxpayers decided that they should sell the houses in order to obtain capital for further construction operations, and that they then "abandoned the purpose of holding the houses primarily for the production of rental income"; concluding that the taxpayers' business from before August 1, 1944, to the end of the partnership's fiscal year ended October 31, 1944, was the sale of houses and that, at the time houses were sold during that fiscal year, they were held by the taxpayers primarily for sale to customers in the ordinary course of their trade or business, and

---

[2] Of course, the Tax Court did not expressly say that it did not believe O'Shea's testimony to be true. Instead, it said (R. 75) that it assumed only *arguendo* that the taxpayers' contentions were sound and supported by the evidence. It was unnecessary for the Tax Court to say that it did not believe O'Shea's explanation of the taxpayers' intentions. To imply, as it did, that it was not satisfactory, or that it did not satisfactorily explain the situation is more polite and less offensive, and at the same time equally sufficient. *Stone* v. *United States,* 164 U. S. 380, 382.

not for investment purposes. (R. 72.) Again we say that the Tax Court here clearly used the word "primarily" in the sense of "chiefly" or "principally." In other words, the Tax Court gave the statute its most liberal construction and that for which the taxpayers contended.

From what has been said, it is apparent that the Tax Court did not use the word "abandonment" in its absolute sense, as the taxpayers conclude. (Br. 21-30.) That is to say, the Tax Court did not, as the taxpayers contend, find or hold that they had entirely abandoned their rental purpose or their rental business prior to August 1944, and that they were thereafter engaged solely in the business of selling houses. The very statement of the Tax Court that they abandoned their purpose of holding the houses "*primarily* for the production of rental income" (italics supplied for emphasis), qualifies the word "abandonment" and negatives the taxpayers' contention that the Tax Court's finding implied an absolute abandonment of their rental purpose.

Moreover, in explaining its finding of abandonment, the Tax Court, in its opinion, repeatedly used the word "change," or "changed." Thus, it said (R. 76) that the taxpayers' original rental purpose was "changed" about February or March 1943 with respect to the 74 houses, at least, and that (R. 77), upon all the evidence, it must be concluded that at some time prior to August 1, 1944, the taxpayers "changed" their "alleged" original purpose with respect to the 95 houses held by them from the purpose of holding them primarily for investment, to holding them primarily for sale, and sold them as they became vacant; concluding (R. 78) that the question in the case became concerned with whether the original purpose of holding property was "changed" and, if so, when.

In support of its view that the taxpayers' original investment purpose, if such existed, was changed in February or March 1944, the Tax Court pointed out in its opinion (R. 75-76) that the taxpayers first decided to sell 74 of the houses and that the evidence further showed that they next decided to sell at least some of the others and that, of the 95 remaining houses, 60 in all were sold between August 1944 and October 31, 1947. The Tax Court further said (R. 77) that the evidence showed that, at some time subsequent to the taxpayers' conference with the bank officers in the middle of 1944, at which the bank suggested (demanded) that they sell some of the houses and pay off some of their loans as a basis for obtaining further loans with which to finance the building of more houses, they did obtain such loans and therewith built such houses, all of which they also sold, except a few which they retained.

We therefore submit that there is ample evidence to sustain the Tax Court's finding that, during the latter part of the partnership's fiscal year ended October 31, 1944, the taxpayer held the houses here in question primarily for sale to customers in the ordinary course of the taxpayers' business within the meaning of Section 117 (j) of the Code (Appendix, *infra*). This is so even though the word "primarily" is deemed to have been used by Congress in this section as meaning "chiefly" or "principally" rather than "essentially" or "fundamentally." And, of course, there can be no question at all about this if "primarily" was used in the latter sense. For in that sense, the taxpayers were obviously engaged in a primary way in the sale of these houses, since their sales activities after August 1944 were substantial in that the sales they made were both frequent and continuous and involved more than two-thirds of the 95 houses which remained after the initial sales of the 74 of them in 1943. Indeed, the taxpayers' sales activities

were far more substantial than their rental activities, if these may be judged by the profits they made in each of the activities.[3] This is best illustrated by the following table so far as the record discloses (R. 70-72, 167):

Fiscal year ended	Rental Profits	Sales Profits
October 31, 1943	$ 1,956.02	$82,691.20
October 31, 1944	4,306.63	27,936.51
October 31, 1945	2,449.40	Not shown in record
October 31, 1946	(1,209.67)*	" " " "
October 31, 1947	629.57	" " " "

* Loss

There remains briefly to consider the taxpayers' contentions (Br. 31-58) that their sales activities in 1944 and subsequent years were immaterial in determining the nature of their activities, regardless of the number and frequency of the sales, so long as the originally contemplated rental operations continued.

The complete refutation of this contention lies in the decisions of this Court referred to in Subpoint B, and cited in the Commissioner's brief (pp. 7-8) in the *Rollingwood* case. As therein pointed out, this Court in the cases of *Richards* v. *Commissioner,* 81 F. 2d 369, 373; *Commissioner* v. *Boeing,* 106 F. 2d 305, 309, certiorari denied, 308 U. S. 619; and *Ehrman* v. *Commissioner,* 120 F. 2d 607, 610, held that the answer to the question whether property was held primarily for sale within the meaning of the capital gains provisions of the statute revolves largely around the frequency and continuity of the transactions claimed to result in a trade or business. And the *per curiam* decisions of this Court in *Field* v. *Commissioner,* 180 F. 2d 170, and *Rubino* v. *Commissioner,* 186 F. 2d 304, rest upon the

[3] The taxpayers argue (Br. 47) that the disparity between income from sales and rentals is not controlling here, citing *Delsing* v. *United States,* 186 F. 2d 59 (C.A. 5th). As we shall hereinafter show, that decision rests upon its own particular facts and is not controlling here, even assuming it to have been correctly decided, which we respectfully question.

same principle. It is, of course, not necessary, as this Court has also held, that the sales activities be the taxpayers' only occupation or business. *Harvey* v. *Commissioner,* 171 F. 2d 952. See also to similar effect, *Snell* v. *Commissioner,* 97 F. 2d 891 (C.A. 5th). Nor is it necessary that he devote any time personally thereto. *Ehrman* v. *Commissioner,* 120 F. 2d 607 (C.A. 9th); *Brown* v. *Commissioner,* 143 F. 2d 468 (C. A. 5th). If so, there can be little doubt that a material change in the taxpayers' activities with respect to property is not to be regarded as without possible tax significance; and whether it is or not must necessarily depend largely upon the character and extent of the change, that is, upon the frequency and continuity of the transactions constituting the new activity.

The four Tax Court decisions cited by the taxpayers under their second point (Br. 31-51), which involve the sale of houses, do not support their contention that the Tax Court resorted to improper criteria in concluding that they had abandoned their rental purpose and that from August 1, 1944, to the end of the fiscal year ended October 31, 1947, they were holding the houses primarily for sale in the ordinary course of their business.[4] A perusal of these cases will disclose that in

[4] The taxpayers also cite other cases involving the sale of securities, livestock, etc. Space will not permit us to discuss these here. It suffices to say that, if the cases which involve the sale of houses do not serve their purpose, cases involving securities and other property obviously cannot do so; for each of these, no less than those which involve the sale of houses, depends upon its own particular facts. We are not unmindful of a fact that the taxpayer has cited the Eighth Circuit's decision in *Albright* v. *United States,* 173 F. 2d 399, and this decision has now been approved and followed by the Fifth Circuit in the case of *United States* v. *Bennett,* 186 F. 2d 407, wherein the court construed the word "primarily" as used in Section 117 (j) to mean "first" or "chief." We believe this construction of the statute to be erroneous and that it thwarts the purpose of Congress to capture the ordinary tax on what obviously is business income, i.e., income derived from the sale of property held by the taxpayer for sale in the ordinary course of his trade or business, even though it is also first used therein.

none of them did the Tax Court undertake to lay down a rule that a taxpayer cannot be deemed to have "abandoned" a purpose to hold F.H.A. financed houses primarily for rent, merely because he continued to rent such houses as he did not sell. Nor do these decisions specify any criteria for determining under what circumstances the taxpayer may be regarded as having "abandoned" a rental purpose as a primary one. To the contrary, as has already been indicated, each one of these cases was decided on its own particular facts, and on the theory that each case presented essentially a question of fact rather than a question of law.

Thus, in *Elgin Building Corp.* v. *Commissioner,* decided February 15, 1949 (1949 P-H T.C. Memorandum Decisions, par. 49,015) (Br. 31, 40), it appeared that three corporations, of which the taxpayer was one, were organized by three individuals who became their sole stockholders, for the purpose of constructing defense houses. The corporations were dissolved and the houses owned by each transferred by it to an agent and trustee of a partnership organized by the three stockholders of the corporations for the purpose of taking over the houses and selling them. Thereafter, the partnership sold the houses. The Commissioner attributed the sales to the corporations. The Tax Court merely held that this was not justified on the facts.

In *Robertson* v. *Commissioner,* decided September 29, 1949 (1949 P-H T.C. Memorandum Decisions, par. 49,234) (Br. 32, 43), the sales of the housing units were held to be exceptional. In the two taxable years there in question only 12 units were sold out of a total of 416 that had been built.

In *Ferguson* v. *Commissioner,* decided March 21, 1950 (1950-P-H T. C. Memorandum Decisions, par. 50,071) (Br. 32-33, 45), the Tax Court specifically recognized the fact that frequency and continuity of

sales was the primary consideration. It refused to apply the test in that case only because, under its particular facts, it appeared that the sales were to tenants who had requested the taxpayer to sell, and further that the taxpayer sold under pressure put upon it by banks to repay loans.

Farry v. *Commissioner,* 13 T. C. 8 (Br. 33, 41), was, as the Tax Court pointed out in its opinion (R. 80), relied on by the taxpayer in this case. But, as the Tax Court said, the taxpayer there had between 1941 and 1944 acquired by purchase or construction about 140 rental units, some of which were duplex apartments. It was not until 1944, however—that is, not until three years later—that the taxpayer concluded to sell any of them. He sold 19 rental properties in 1944 and 27 in 1945, which had been rented from 6 months to more than 11 years. The Tax Court said that it seemed to it that the taxpayer had proved by overwhelming evidence that the rental properties were held primarily for investment and that the fact that he had received satisfactory offers for some of them and sold them does not establish that he was holding them primarily for sale to customers in the ordinary course of his business.

There remains only to consider the case of *Delsing* v. *United States,* 186 F. 2d 59 (C.A. 5th), already adverted to, which the taxpayers cite in their brief (pp. 34, 47-48). In that case, the Fifth Circuit reversed the decision of the Tax Court holding that the F.H.A. financed houses there in question were held by the taxpayer primarily for sale. While we think that the Fifth Circuit should not have reversed the Tax Court's findings in that case, we recognize that that was a close case. The court pointed out that the houses were constructed under definite restrictions as to their sale and were rented from 1942 to 1945, without any sales

being made. Sales were then effected because returning veterans sought to buy them. It is quite true, as the court said, that the Commissioner had relied primarily upon a statement in the taxpayer's priority application to the effect that the houses were to be built for sale and rent, and that during 1945 the taxpayer's income from sales greatly exceeded its income from rent. However, the court thought that the statement in the application had been over-emphasized in view of the restrictions actually placed upon the sale of the houses, and it regarded the disparity between income from sales and rent as not controlling. Of course, the circumstances here are entirely different. Thus, regardless of whether the *Delsing* case was correctly decided or not, so far as concerns any question of law which the Fifth Circuit was called upon to apply in that case, its decision therein stands only for the proposition that, under the particular facts of that case, the finding of the Tax Court was clearly erroneous.

CONCLUSION

For the reasons stated, the decisions of the Tax Court should be affirmed.

Respectfully submitted,

Theron Lamar Caudle,
Assistant Attorney General.

Ellis N. Slack,
A. F. Prescott,
Carlton Fox,
Special Assistants to the Attorney General.

April, 1951.

APPENDIX

Internal Revenue Code:

Sec. 117. Capital Gains and Losses.

*　　*　　*　　*　　*

(j) [As added by Sec. 151 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and amended by Sec. 127 of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of Property Used in the Trade or Business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l) held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k) (1) or (2) is applicable.

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and

losses from sales or exchanges of capital assets hold for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. For the purposes of this paragraph:

(A) In determining under this paragraph whether gains exceed losses, the gains and losses described therein shall be included only if and to the extent taken into account in computing net income, except that subsections (b) and (d) shall not apply.

(B) Losses upon the destruction, in whole or in part, theft or seizure, or requisition or condemnation of property used in the trade or business or capital assets held for more than 6 months shall be considered losses from a compulsory or involuntary conversion.

* * * * *

(26 U. S. C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.117-7 [As amended by T. D. 5394, 1944 Cum. Bull. 274, 276]. *Gains and Losses from Involuntary Conversions and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—Section 117 (j) provides that the recognized gains and losses

(a) from the sale, exchange, or involuntary conversion of property used in the trade or business of the taxpayer at the time of the sale, exchange, or involuntary conversion, held for more than six months, which is

(1) of a character subject to the allowance for depreciation provided in section 23 (l), or

(2) real property,

provided that such property is not of a kind which would properly be includible in the inven-

tory of the taxpayer if on hand at the close of the taxable year, or is not held by the taxpayer primarily for sale to customers in the ordinary course of trade or business, and

*   *   *   *   *

shall be treated as gains and losses from the sale or exchange of capital assets held for more than six months if the aggregate of such gains exceeds the aggregate of such losses. If the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets.

*   *   *   *   *

☆ U. S. GOVERNMENT PRINTING OFFICE: 1951   938819   693